DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 1759
La Jolla, Calif. 92037

36 Letters per Year — $75 Annually

Registered with the Securities Exchange Commission

July 8, 1971 Letter 500

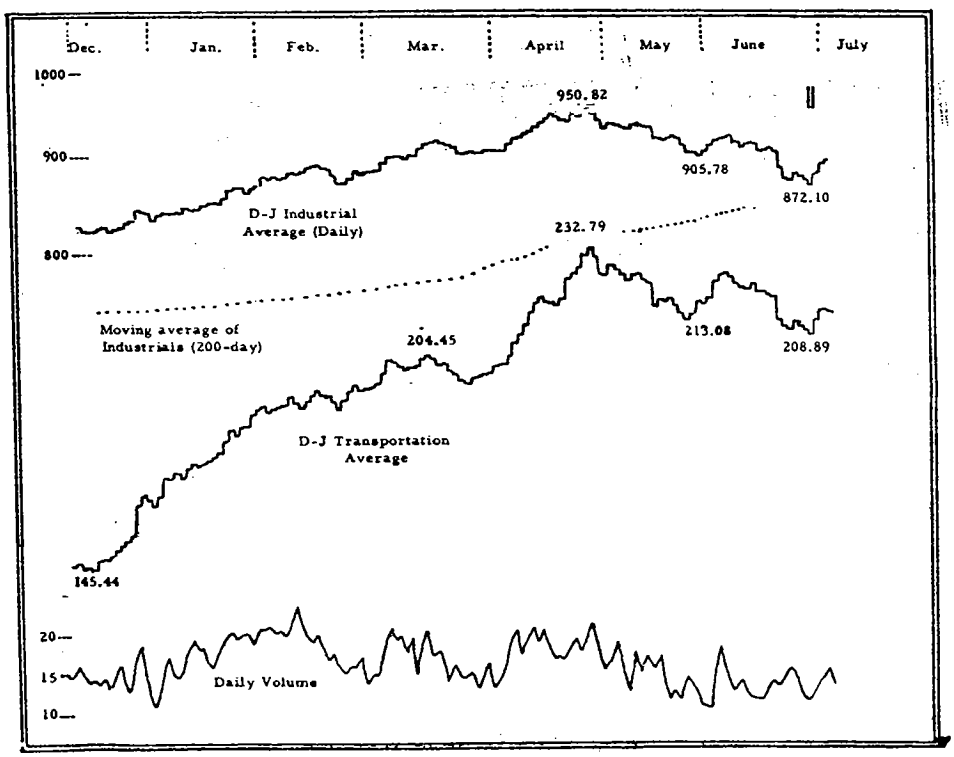
THE MARKET: From the standpoint of Dow Theory, the "marker-points"for the Averages are clear enough. We have the 1971 recovery highs of 950.82 (Industrials) and 232.79 (Transports), and those levels, of course, represent the the late-April highs. On the downside we have the June 28 lows of 872.10 and 208.89. On a simple "reading", a bettering of the April peaks by both Averages will signal a continuation of the recovery, while a breaking of the June lows will indicate that the path is freshly greased for another downside slide.

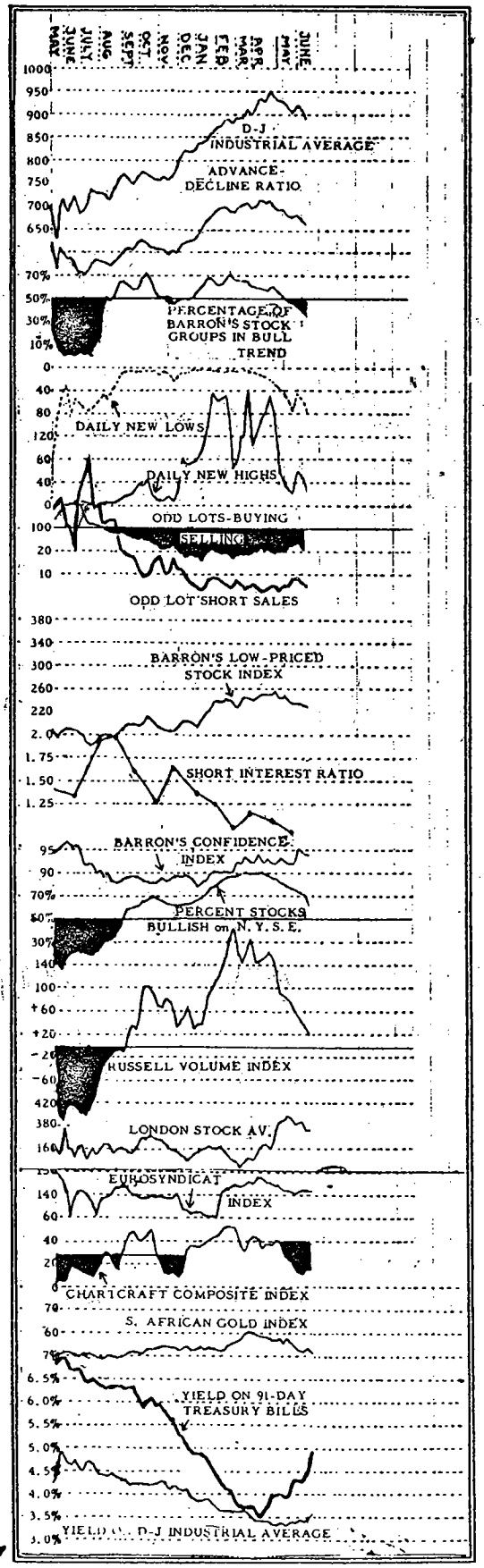
The Utility Average (which I always watch) struck its low on June 8 at 113.11, three weeks prior to the low in the Industrials and Transports. However, the D-J 40-Bond Average, which should always confirm the Utility Average, made a new low on its descent from its March peak, hitting 69.94 on July 1 (this was its lowest level since January 8).

It seems clear that we are now witnessing the "summer rally", and at this point I would say that the most interesting technical relationship is that of the Dow and the advance-decline ratio (see page 2 chart). Note that on its recent steep descent, the A-D ratio (which measures the advancing or declining tendencies of the majority of N.Y.S.E. stocks) broke far below its February low. In fact the A-D ratio by June 28 had wiped out literally its entire 1971 gains, plunging to its lowest level since January 5.

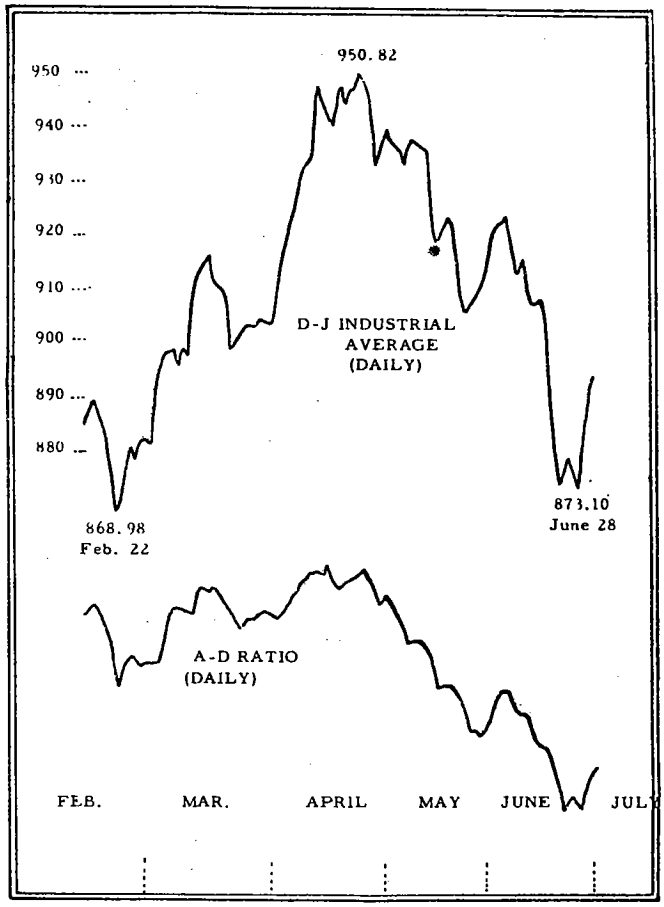
The slide in the A-D ratio (although reflected in the majority of stocks) was not confirmed by the Dow Industrial Average. Note that on the decline the Dow held 5 points above its February 22 low of 868.98. Had the Dow confirmed the A-D ratio in its descent, it would have plunged to its January 6 low of 837.

The downside non-confirmation by Industrials set up the technical pattern for the



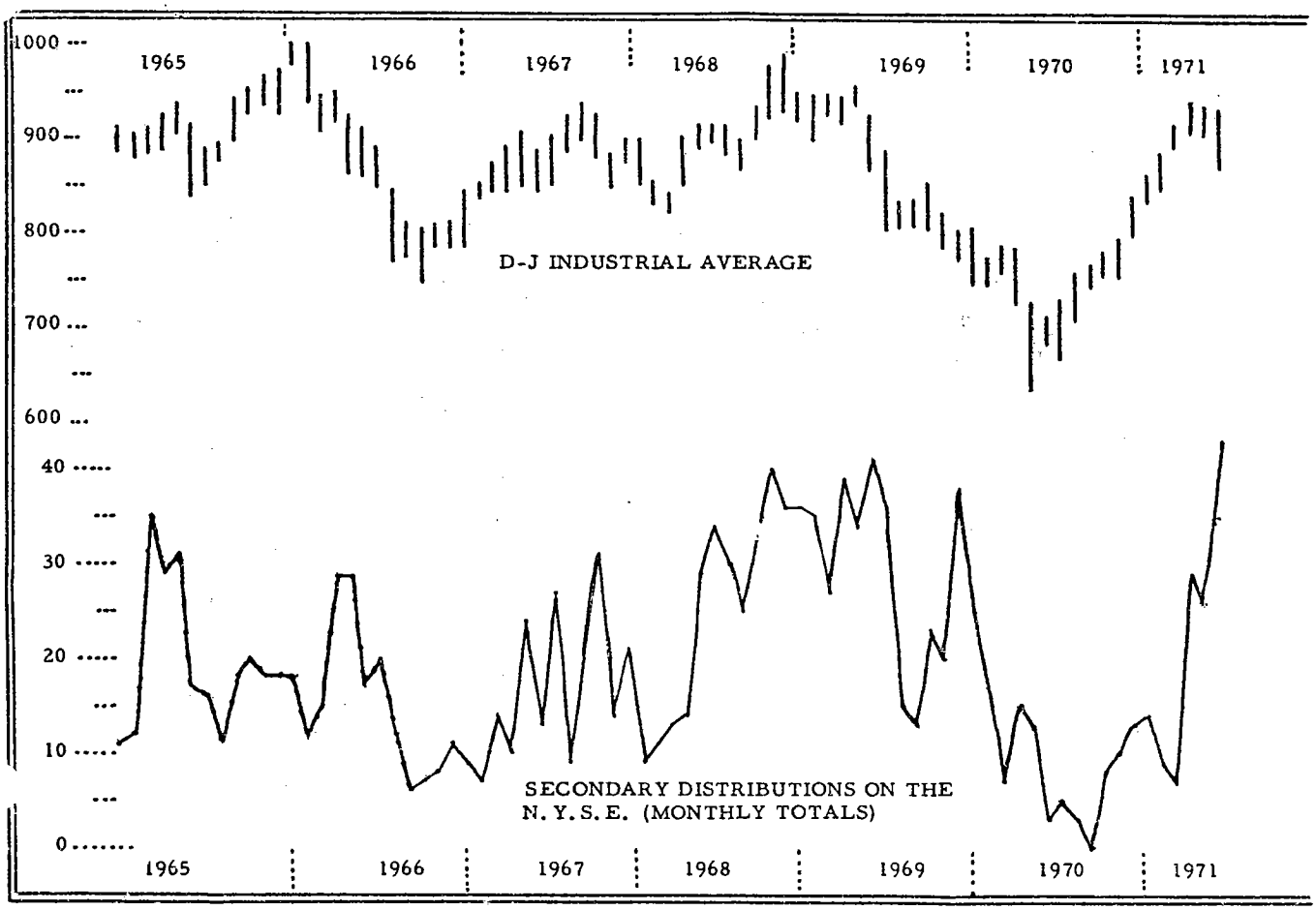


current rally. The dilemma, however, is that the damage to the A-D ratio has been so severe that it would take an extraordinarily powerful and persistent advance to bring the two indicators (i.e., the Dow and the A-D ratio) "into gear" on the upside. What I think the more likely pattern is going to be is a rally by the Dow which will evince increasing weakness on the part of the A-D ratio, followed by a renewed and far more serious decline by the market once it becomes clear that the advance is merely serving to heighten the divergence between the "bouncing" power of the Dow and the sluggishness on the part of the majority of N.Y.S.E. issues.



NEW STUDY: With this Letter I am introducing a new study (below) which I believe is going to prove valuable. On the accompanying chart we see the monthly high-low range of the Dow Industrials going back to 1965. Below are the monthly totals of secondary distributions as computed from Barron's weekly statistics.

Basically, a secondary is a distribution of (usually) a large block of stock through one or more brokerage firms. The secondary is sold on an underwriting fee basis, rather than a commission, and thus it is more interesting from the standpoint of the broker (since the underwriting fee will usually be larger than a commission). Most large secondaries are registered in advance (there is a 30-day registration period), and large secondary stock issues will often be "supported" by the houses engaged in the distribution.



As a rule, the best time to get off secondaries is during a good market. In a market that is roaring ahead or at least churning up alot of volume, secondaries can be disposed of with little trouble. In a collapsing market, where prices are eroding away, obviously a secondary distribution would be "the straw that breaks the camel's back" (or in this case, the straw that breaks the back of the price structure of the stock in question.

Now a secondary is a distribution to the public, and the number of secondary offerings is a good gauge of the amount of distribution which is going on. If you study the chart you will note that a "warning level" was reached in the summer of 1965 when the secondary index rose to 35. Later, during April and May of 1966 secondaries reached 29 during each month. This accompanied the final distribution around the 1966 bull market top.

The Dow fell from 995 in February, 1966, to 744 in October, 1966. By October, 1966, secondaries had dropped to a low of 6. The Dow pushed up again, hitting a 1967 high of 943 in September. In September there were 25 secondaries and in October there were 31. The Dow dropped back to a low of 825 in March, 1968, while during February and March of 1968 secondaries trailed off to 9 and 11 respectively.

A major warning signal was provided during mid-1968 when secondaries (June) rose to 34. By October, 1968, secondaries had climbed to 40. In December the Dow touched its peak of 985, and the big smash of 1969-70 was on its way.

By May, 1970, secondaries had dropped to 3 for the month as the Dow sank to a low of 631. July, 1970, brought forth only 3 secondaries, August showed none. The big upward correction in the bear market was on.

In April, 1971, with the Dow in the 950 area, secondaries rose to 26. By May the index gave a definite bearish warning as secondaries totaled 35 for the month. Last month (June) the index was screaming danger as the total of secondary distributions rose to a record 43!

Conclusion: The secondary index tends to provide warnings when it climbs above 30, while anything around 40 or above is a major danger area. Conversely, the market may be bottoming out when secondaries run below 10 per month. The current 43 total for June is a stern warning signal. It is above anything seen during late-1968 or early 1969.

BULLISH PERCENTAGES: One of the technical studies which I have found helpful is my chart of the percentage bullish categories compared with the Dow. On the accompanying page 4 chart we see the Dow Industrials plotted above the "percentage of all N.Y.S.E. stock in bullish trend," "the percentage of stock groups in bullish trends," "the percentage of the 30 Dow Industrials in bullish trends." These computations are provided weekly by Chartcraft, Larchmont, N.Y.

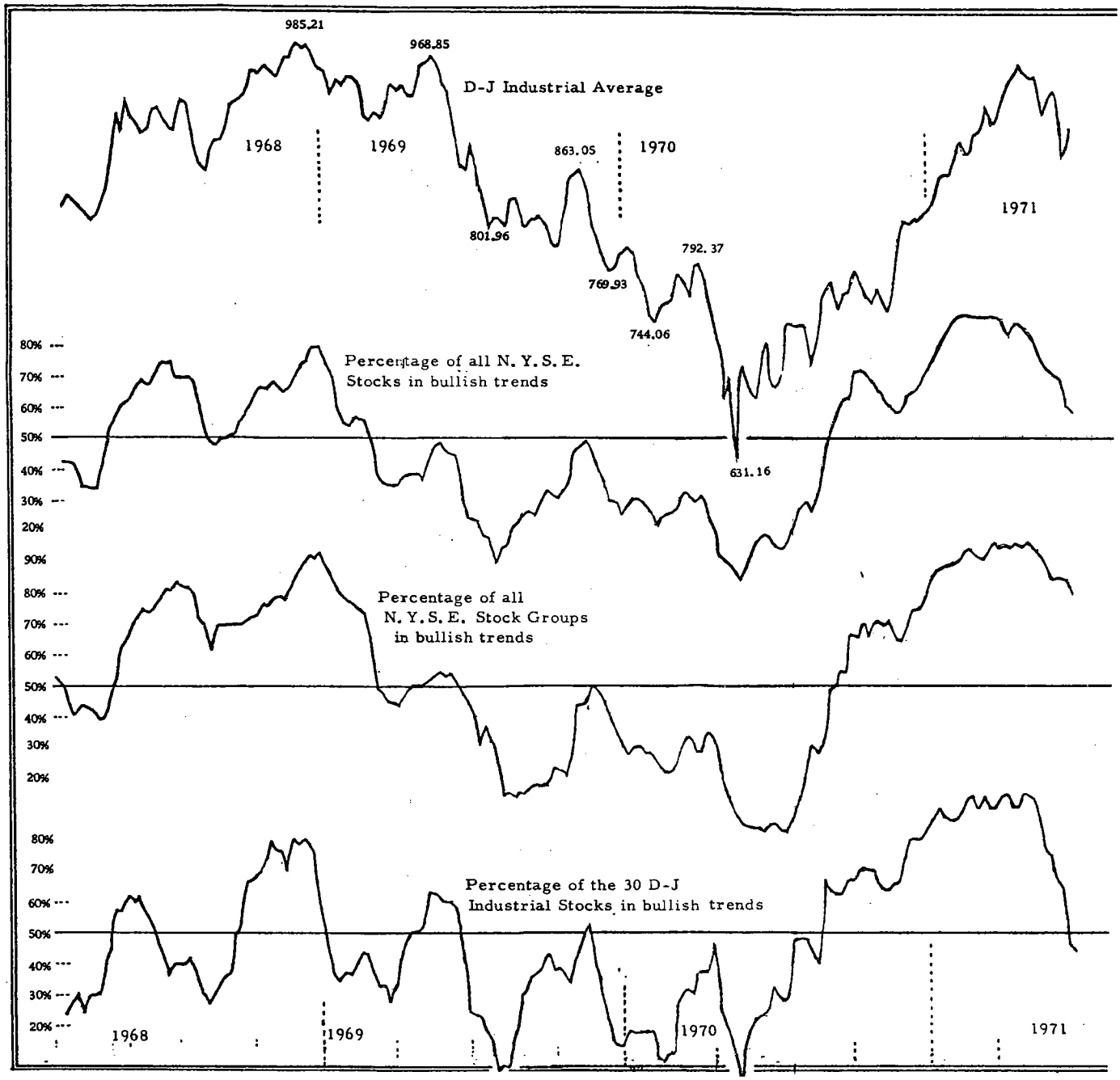
The order of movement is both interesting and informative. Most sensitive is the percentage bullish in the 30 Dow stocks. This indicator usually makes its move first. If the movement is to be an important one, it is shortly confirmed by the percentage bullish in all N.Y.S.E. stocks. Final confirmation comes from the percentage bullish in the groups.

The critical level on all three indicators is the 50% level. This is shown by the horizontal black line on the three indicators. Note that the 30 Dow stocks dropped below 50% bullish during the second week of 1969. This was the first important warning signal, following the actual 985.21 top in December, 1968. Nine weeks later the percentage of all stock bullish dropped below the critical 50% level. Two weeks after that the percentage of all groups sank under 50%. A weak rally followed which took two of the indicators (but not the bullish percentage of all stocks) above the 50% level, and after this came the great 1969-70 smash. Note that the bearish signals on the three indicators came very early in the 1969-70 decline.

On the big 1970-71 rally, the Dow bullish percentage climbed above 50% on August 26. On September 16 both the all-stock bullish percentage and the group bullish percentage climbed above 50%. This meant (with all three categories above 50%) that the upward correction was going to be a major one.

On February 18, 1971, the all-stock bullish percentage topped out at 91.2% bullish and moved sideways, then began sliding. On March 10 the 30 Dow bullish percentage topped out at 93.3% bullish, then moved sideways and down. On May 5 the percentage of groups bullish peaked at 96.9% bullish, then sank.

Two weeks ago (week ending June 23) the first bearish signal was provided by this chart as the bullish percentage in the 30 Dow stocks dropped below the critical 50% level — to 46.7%. Last week saw a further drop to 43%, while at the same time (week ending July 2) the bullish percentage of all stocks (declining but still above 50%) was at 58%. July 2 also saw the bullish percentage of groups at 79%, sinking slowly but still far above the 50% level.

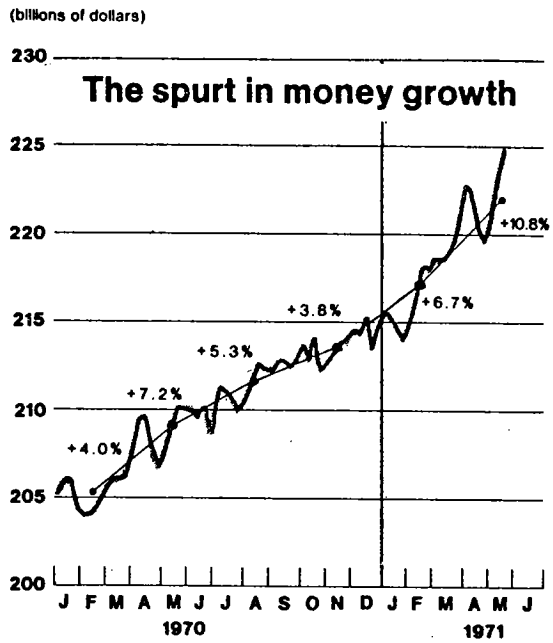


These indicators can be very useful for timing and for identification of a major "oversold" condition in the market. For instance, at the 1970 lows, all three indicators dropped below the 10% level, indicating a market which had been literally smashed to its knees. Interestingly, at the recent top all three indicators were in the top 10% area (or above 90%).

Conclusion: The percentage bullish in the 30 Dow Industrials has dropped below the 50% level, thus rendering a first bearish signal. If this is the start of the next major collapse in this bear market, we should, in time, get confirmation from the other two indicators. If all three indicators go below 50%, the odds favor a decline that will assume major, even tragic proportions. Such a decline will probably not terminate until the three indicators are down around (or below) the 10% bullish area.

THE PICTURE: The ever-hopeful Business Week (June 26) noted in its Business Outlook column, "The freshening of inflation confronts the Administration with some unpleasant facts. A business speedup is needed to bring down unemployment. But inflation is already reviving even without thespeedup. That means that Game Plan No. 2 is going by the boards."

The authoritative Monthly Economic Letter (June) of the First National City Bank notes that the Fed is now suspended on the prongs of a three-horned dilemma. The Fed has inflated the money supply during 1971 in a manner not seen since World War II (see chart). Inflation is now roaring again. "The Fed," states the report, "has virtually no room for maneuvering. This departure from its earlier anti-inflation monetary growth path is far more serious than any since the Fed embarked on this path in the early part of 1970." The bank then states that the Fed has three paths, it could swing back to a 5-6% money growth rate, but this would still be a big inflation spur. Or the Fed could hold the money growth at zero for the rest of the year, but this might whipsaw the economy to the downside. Or the Fed could restrict open-market operations, thereby contracting bank reserves and reducing the money supply. They could do this for a short period in an effort to undo the damage done by the earlier ballooning of the money supply, but the bank (which prefers this avenue) notes that this could push short-term interest rates to much higher levels.



"Rising interest rates will bring some political risks in the short run," says the Bank, "But in the long run, it is difficult to see any political gain for the Administration or the Fed in an inflationary policy." Perhaps it is no coincidence that the current "in" word for what is occurring in the U.S. economy is "stagflation".

The latest issue of Time magazine heads its Business section with an article entitled "Nixon's Dilemma: A Boxed-In Economy." I don't often agree with Time's analysis but I must say that "boxed-in" rather accurately describes my view of the situation. On one side we have an unsustainable explosion in the money supply, and on the other side we have huge deficits, high unemployment, galloping inflation and vicious foreign competition. On June 29 President Nixon (torn between fears of inflation and hopes that the economy will expand, thereby lowering unemployment), announced that (1) he is not going to institute wage and price controls, (2) he is not going to ask Congress for tax relief, and (3) he is not going to increase spending. Thus, the picture is for a hands-off Government policy, probably a more conservative stance on the part of the Fed, and an unending stream of "hopes and wishes" from Washington. If the economy slumps in the fall, I predict reversals in policy all along the line, sprinkled with generous portions of consternation and frenzy.

On June 29 it was announced that the U.S. suffered a trade deficit in May (following an April deficit) to produce the first two-month in a row deficit in 21 years. On top of that, the Government showed a $25.6 billion Federal budget deficit for the first 11 months of the fiscal year ending June 30. This is a staggering figure for 11 months, and it leads me to believe that the 12-month deficit will be around $28 billion, with the combined 1971 and 1972 deficits perhaps reaching the astronomical sum of near $50 billion! I can only say that the fiscal problems and dilemmas which will arise over the next few years are going to be far, far greater than almost anyone now believes possible. If, on top of this, business turns down, the problems will explode like a volcano, and the repercussions will be heard around the world.

Stans Warns U.S. May Suffer Trade Deficit

WASHINGTON (UPI) — Commerce Secretary Maurice Stans warned that a "deteriorating" international trade performance may give the United States its first trade deficit in 75 years.

"This is a unique situation in this country's history," Stans told the Foreign Economic Policy Subcommittee of the Joint Economic Committee of Congress. "The equations of international economics are changing rapidly and profoundly -- and are seriously affecting the United States."

In a written statement, Stans said it appeared the United States this year would have a trade surplus of $1 billion or less. But while responding to questions, he appeared more pessimistic and told the subcommittee the country "may end up this year with a trade deficit for the first time in 75 years."

"It is no secret that our trade performance has been deteriorating," Stans said.

During the first half of the decade of the 1960s, the American trade surplus reached $7 billion annually. But the balance has dwindled since.

"In 1968 and 1969, our trade surplus averaged only about $1 billion," Stans said. "It temporarily recovered to $2.7 billion in 1970, but has fallen again."

American companies are at a disadvantage, Stans said, because American antitrust laws are more restrictive than those of trade competitors.

In closing this section, I would like to quote friend Harry Schultz from his latest June Letter: "The Fed must raise $20 billion in the second half of 1971. The Treasury admits it'll be taking one-third of all money raised in credit markets (up from 12% in 1969). Politically, this means the U.S. is becoming a superstate, which 'hires' its population to run its branches, instead of a country of people who hire a government to run its public services. Economically, it means a new credit crunch and a draining of the stock market of its life-blood."

HERE ARE SOME QUESTIONS and answers which I have picked on the basis of how widespread interest is in each of these subjects (judged from letters received here).

Q...Do you still think that this is a poor time to hold real estate and land? If inflation continues at the current flagrant rate, won't the price of everything continue up?

A...I believe that inflation in retail goods and consumer items could continue for a while longer, but already many industrial products such as lead, certain steels, aluminums, are either weakening in price or subject to "price concessions" on large

purchases. All across the economic front troubles are mounting as evidenced in credit collections, liquidity, bankruptcies, but most serious of all are the large areas in which profits are being squeezed unmercifully.

The end result is going to be a gathering recession, then a depression. When profits decline and unemployment rises, deflation will sweep across the land. Even overseas business is now slowing down with the German boom almost over and Japan last month sustaining her biggest drop in GNP in years.

Those who hold property and land for speculative reasons, I feel, are going to be bitterly disappointed in the years ahead. I expect the bottom to fall out of all marketable "things" except gold. I know this sounds almost impossible in the face of the currentwidespread, relentless inflation. But I will repeat what friend Eliot Janeway says: "M.R.O., " which means "the money is running out".

Q...I'm still holding my gold shares, but I'm getting impatient. Do you still think I should continue to hold my gold shares?
A...I am going to start with a quote from Alden Well's latest Monetary Report. "Europeans are aware that Gresham's Law will raise the price of gold. For more than a generation the American government has attempted to shield the American public from this knowledge, because it wished to have a free hand in the issuance of paper. Now that this mission has been accomplished, it too is bewildered. "

Since the late 1970 lows, the South African gold index has risen from 45 to the current 54. The Barron's average of U.S. and Canadian gold issues has risen from its late-1970 low of 89 to the current 140. I continue to suggest that subscribers hold 10% to 15% of their assets in assorted gold mining issues as a hedge against a collapse of the dollar and a major rise in the price of gold.

The fact is that the U.S. is now running into probably the roughest trade competition in its history, and this is showing up in diminishing U.S. international monetary reserves. In June the U.S. sold $50 million of gold toSwitzerland. With a deduction of $559 million in gold which we owe to the IMF, the U.S. (see Barron's, June 28, page 20) gold stock has dropped under the critical $10 billion mark. Therefore, it would not surprise me if a gold embargo were to appear any time now.

Q...Shouldn't the Dow Industrial Average be adjusted for inflation? In the June 14 issue of Barron's a Letter to the Editor states that if the Dow were subject to the same adjustment which the GNP figures are (in order to produce GNP in constant dollars), the three Dow tops of 995 in 1966, 985 in 1968 and 950 this year would be adjusted to read 888 in 1966, 801 in 1968 and 679 in 1971.

A...Robert Rhea stated that the Averages discount everything, and he was specific in including inflation in that reckoning. I agree with Rhea, the Averages automatically adjust for inflation, and one way they do it is in their price-earnings ratios. With inflation rampant, the Dow is currently selling at 17 times its earnings for the year ending March 31, 1971. The Dow had sold as high as 18 times earning this year.

In the second quarter of 1949, when deflation was considered the order of the day (how wrong that was), the Dow sold for 7 times earnings. If the Dow were now to sell on the 1949 basis, it would sell at around 7 times earnings of perhaps $52 or around 360. Thus, in my opinion the Dow does adjust for inflation and deflation. Just let investors believe that deflation is here, let them believe that earnings are heading down, and let them revise the price-earnings ratio down, and we'll get all the adjustment we need. And that is just what will probably happen over the several years ahead.

Q... Would you hold any mutual funds at this time?
A...I think mutual funds are fine during bull markets. During bear markets I would avoid them as I would avoid any other equities or market instruments (except Treasury bills). Many fund managements are excellent, others are not. But in general, the trend of fund prices tend to go with the trend of the overall market. On this basis alone, I would not hold funds during this primary bear market, regardless of rallies or declines.

A second consideration which I discussed in the last Letter is the current low fund cash holdings, and the current historic first — the fact that the funds are now losing more money in redemptions than they are taking in on purchases. I include a chart (from the N.Y. Times) showing both of these situations. This whole phenomenon could prove to be very serious, and could actually result in the funds exerting a steadily and relentless downside pressure on the market.